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HAROLD B. WILLEY, Cle

SUPREME COURT OF THE

UNITED STATES

OCTOBER TERM, 1954

No. 734

VERMONT TRANSIT CO., INC.,

Petitioner

vs.

COMMISSIONER

OF INTERNAL REVENUE

Petition for a Writ of Certiorari to the
United States Court of Appeals
for the
Second Circuit.

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FILED , 1955.

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1954

No. .....

VERMONT TRANSIT CO., INC.,

Petitioner.

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent.

Petition for
Writ of Certiorari to the
United States Court of Appeals
For the Second Circuit

To Honorable Earl Warren, Chief Justice of the United States, and the Associate Justices of the Supreme Court of the United States:

Your Petitioner, Vermont Transit Co., Inc., a corporation under the laws of Vermont with principal office at Burlington in that State, respectfully shows:

1. Opinions in the above entitled cause in the courts below are reported in 19 Tax Court Reports 1040, and the Court of Appeals for the Second Circuit in 218 Federal Reporter Second 468.

2. The jurisdiction of this Court is invoked for the purpose of securing a review of a judgment of the United States Court of Appeals for the Second Circuit dated and entered January 21, 1955, pursuant to jurisdiction conferred upon this Court 28 U.S.C. sec. 1254 (1), 62 Stat. 928.

Petitioner alleges that in this cause the Court of Appeals has decided a federal question to wit, a question under the Internal Revenue Code of the United States, in a way which is in conflict with applicable decisions of this court and also in conflict with the decision of other United States Courts of Appeal on matters of like legal import.

3. The question presented for review is:

Where operating rights as a common carrier by motor vehicle were acquired by petitioner under a contract whereby seller was to receive a cash pay-

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ment and a share in the earnings as such, for a five year period, with no provision for any possible alternative compensation, and petitioner never had or claimed command of, or right to, these earnings, or any benefits from them, either by reduction of any debt or enhancement of its assets or increase of privileges or decrease of duties, was seller's share of the earnings income to it or a capital investment by, and income to, petitioner?

4. The statute involved is Section 22 (a) of the Internal Revenue Code, 26 U.S.C. (1940 ed.) sec. 22 (a), 53 Stat. 574 pertinent provisions of which are as follows:

SEC. 22. GROSS INCOME

(a) GENERAL DEFINITION. — "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.
* * * *

5. This proceedings originated in a petition to the

Tax Court of the United States by Vermont Transit Co., Inc., Petitioner, against Commissioner of Internal Revenue, Respondent, filed May 8, 1951, therein praying that the Tax Court determine that there was no deficiency in taxpayer's income tax for the years 1942 and 1943, but an overpayment and that refunds of the overpayments be allowed. The Tax Court denied the petition March 10, 1953, whereupon, June 9, 1953, Petitioner brought its petition for review by the United States Court of Appeals for the Second Circuit and said petition for review was denied and the judgment of the Tax Court was affirmed.

The facts involved in this litigation were not in dispute. All were stipulated and "so found" by the Tax Court.

The question grew out of a written contract providing for the transfer to petitioner of certain rights to operate as a common carrier of passengers by motor vehicle, in consideration of a cash payment of $3,500 by petitioner and its obligation to pay into an escrow account, for annual division between the seller and the buyer, revenues, if any, in excess of agreed operation costs during a so-called "contract period" of five years. (Stip. Ex. 7-G. App. pp. 45-47).

Seller, Frontier Coach Lines, Inc., and petitioner were both common carriers of passengers by motor vehicle. Frontier was in financial straits and was operating under the franchises involved in this litigation at a persistent loss. (Stip. Ex. 6-F. App. p. 40). The first contract between the carriers was a so-called lease of the operating rights

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for five years, on a profit sharing basis, with renewal option, supplemented by a purchase option. (Stip. Ex. 4-D. App. p. 26, Ex. 5-E. App. p. 32). The "lease" was made subject to approval by the Interstate Commerce Commission. It did not become effective. A proposed report of a commission examiner recommended that approval be denied because the prolonged deficit from lessor's operation called for "a more permanent solution than a short term lease" which, if the purchase option was not exercised, "would merely postpone the day of reckoning". But it was recommended that the application be denied without prejudice to submission by the parties of an application embracing revised terms for purchase of the rights. (Stip. Ex. 6-F. App. pp. 40-42). Thereupon the parties made the sale contract from which the present issue arises.

Nearly identical provisions of the lease and sale contract required petitioner, during a five year "contract period", to maintain operations over the described routes and not to abandon or change them during the "contract period"; to control and be responsible for the operations; to hold Frontier harmless from claims arising out of operation; to furnish monthly statements thereof, including revenue collected and miles operated. (Stip. Exs. 4-D App. pp. 31-32 and 7-G, App. pp. 47-48). Frontier was obligated to furnish during the five year period connecting bus service, without any provision for compensation. (Ib.) Other provisions of both instruments prescribe precisely the disposition of revenues resulting from the operation, viz.: petitioner was authorized to "retain" its agreed

operating costs, called the primary amount. In the sale contract it was permitted to retain also the first $3,500 above this primary amount. This was the sum it paid in cash for the franchises. Petitioner was required to pay into an escrow account all revenues which it was not thus specifically authorized to retain. (Stip. Ex. 7-G. App. p. 47) From the escrow account Frontier was to receive on annual settlement "all revenues" up to one cent for each mile of operation. "Any and all revenues in excess" of these amounts were to be divided between the parties. (Stip. Ex. 7-G. App. p. 46).

Buyer assumed no obligation to make any payments in excess of the $3,500 and had no control over the disposition of the revenues to be paid into escrow and no benefits from seller's share, whatever its amount. Seller had no means of securing any payments on account of its franchises, other than the $3,500, except through its share of the revenues paid into escrow. The issue was whether seller's share of the revenues was income to buyer.

Petitioner claimed that under the rule established by the precedents, seller's right to share in the revenue constituted a reservation of an economic interest for the five year "contract period" and the prescribed method of operation was a profit sharing enterprise; that therefore the revenues passing through escrow to seller were income to seller and not to petitioner as the buyer.

The Court of Appeals, relying upon the fact that title had been transferred to buyer in consideraion of the cash payment and the payments from revenues, with control of and responsibility for

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operations expressly conferred upon buyer, inferred "that the device of contingent payment was used as a way of arriving at a fair purchase price" and held that therefore the portion of the revenues passing through escrow to seller represented purchase money and thus could not represent a reservation of interest. It held that this conclusion was not inconsistent with the authorities cited by petitioner.

In a dissenting opinion, Judge Swan quoted from the facts stated in the opinion of the Tax Court, and concluded that the substance of the transaction was a joint enterprise for five years, the earnings of which were to be shared; and that the authorities cited by petitioner on the question of reserved interest were not distinguishable in principle.

6. The decision of the court below is in conflict with two groups of decisions of this court.

A. One of these groups is composed of repeated decisions that when property is transferred in consideration of cash and the right of seller to a share in its future earnings, if seller has no means of securing compensation in lieu of such earnings, they are income to seller and not a capital investment by buyer.

In *Thomas* v. *Perkins*, 301 U.S. 655, the transfer was (p. 657) "in consideration of a cash payment" and "of the further sum of $395,000 to be paid out of the oil produced . . . ." Because the $395,000 was to be paid only from the oil produced with no personal obligation on the buy-

er to pay from any other funds, this Court concluded (p. 659) that it was the intention to withhold from the operation of the grant the oil which was for the benefit of the transferror. That this was the meaning of the judgment was emphasized by the dissenting opinion (p. 663) of two judges who thought the oil produced was not any the less income to the transferee "because he agreed to apply a part to payment of the purchase price of the lease and gave an equitable lien to secure the payment."

In *Burton-Sutton Oil Co.*, v. *Commissioner*, 328 U.S. 25, the contract imposed the obligation to develop oil land and required the grantee-operator to pay to the assignor half of the net income from operations. The question was whether this half of net represented an economic interest retained by a grantor or a capital investment by the grantee and successors. It was held to represent a retained economic interest (pp. 32, 35); that neither the nature and form of the document providing for the transfer, nor (p. 33) the technical title to the property, nor (p. 33) the medium of payment was material; that (pp. 35, 36) a right to payment dependent solely upon sale of oil produced is what marks an economic interest; and that each of successive assignors who retained a right to share in the proceeds, retained an economic interest.

In *Anderson* v. *Helvering*, 310 U.S. 404, it is recognized that whether a share in the revenues represents a reserved economic interest does not depend (p. 441) upon the "formalities of the con-

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veyancer's art" or (p. 412) upon the absence of expressed reservation of title interest, but upon the practical consequences of payments out of earnings. If seller's right to payment is dependent wholly upon the proceeds of oil produced, it has an economic interest; but if it may secure the payment otherwise, as by sale of the land producing the oil, the right to payments does not represent a retained economic interest. The issue in the case was the right to a depletion allowance, but like *Thomas* v. *Perkins*, supra, and other cases, it held (p. 407) that the right to a depletion allowance was determined by the same basic issues as the liability to taxation for the earnings as income.

In *Kirby* v. *Commissioner*, 326 U.S. 599, a lease for the production of oil and gas was in part upon consideration of the lessee's undertaking to pay the lessor 20% of net profits from operations. The question was whether the lessor or lessee was entitled to a share in the depletion allowance based on this 20%,—that is, in effect whether the 20% was income to the lessee or was the proceeds of a reserved economic interest of the lessor and therefore income to it. It was held that the payments represented a reserved economic interest because such an interest results from a right to share in net profits as the sole means of securing payment.

The instant case is within the rule of the above cases since no payments to seller, after the $3,500 cash payment, was either required, or in any way possible under the contract, except the payments which the contract specifically described as revenues. (Stip. Ex. 7-G. (III) and (IV) App. pp.

46-47). After buyer had received $3,500 in revenue in excess of the primary amount, "all revenues in excess of the 'primary amount' " up to one cent per mile operated "shall be payable in its entirety to the seller". "Any and all revenues in excess . . . shall be divided between the parties . . . . ." There was no alternative.

The opinion below contains no justification of a distinction between this case and the decisions cited above. It refers to only two of them, *Anderson* v. *Helvering*, 310 U.S. 404, and *Thomas* v. *Perkins*, 301 U.S. 655. As to these and as to certain decisions of the courts of appeal, referred to below, it held that "there is nothing in the law to which they advert inconsistent with our result here"; that they are not "controlling with respect to the narrow factual issue upon which this case must turn". This can refer only to the inference drawn by the court below that the income payment was used as a way of arriving at a fair purchase price. This inference is itself inconsistent with the cases as well as the undisputed facts in this record.

It is obvious that the true value or fair purchase price of the oil rights involved in the above cases could not be known when the contracts were made. The contracts contemplated exploitation by the transferee. The provision for sharing earnings correlated the moneys to be received by the transferor with the fair value which might develop from exploitation of the rights by the transferee. But this way of meeting the problem of unknown

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value was not deemed by this Court to make the retained earnings a capital investment.

In the instant case operations under the transferred rights had been conducted at a loss by the seller, Frontier Coach Lines, Inc., in all but two years between 1929 and 1940. (Stip. Ex. 6-7, App. p. 40). The earning power, if any, under operation by petitioner could not be known at the time the contract was negotiated. Although seller's share of the revenue was related to the earning power under operations by petitioner, it was not a reasonable measure of fair value. The share was primarily based on miles of operation and only secondarily on the profits from the operations. It affords less basis for the inference drawn by the court than do the facts in any of the cases cited. There is no circumstance in the instant case which was absent in the cases discussed above and is indicative, in the least, that seller's share of the revenues during the "contract period" was a capital investment by petitioner. The arrangement for division of earnings originated not in the sale contract but in the "lease" contract providing for a joint enterprise with any earnings shared. Frontier contributed the use of the franchises and a connecting service. Petitioner contributed its operational skill and efforts. Clearly no capital investment could be inferred.

Nothing in the sale contract indicated a change in the plan for operation as a joint enterprise for five years. During this "contract period" buyer had no more control over operations and no less restraint under the sale contract than under the so-

called lease. It had no more right to control the net revenues or do anything with them except pay them into an escrow account for annual division. Under the purchase contract as under the lease, buyer's rights and obligations were entirely unaffected by the amount, if any, of revenue which went to seller. The fact that the sale contract provided for a transfer of title which would prevent duty to operate ever reverting to Frontier (thus meeting the requirements of the Interstate Commerce Commission) did not change the character of the five year arrangement as to tax consequences.

It was said in *Griffiths* v. *Helvering*, 308 U.S. 355, 357-358:

> "We cannot too often reiterate that 'taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid.' "

B. Under another group of decisions of this court, the contract rights of the seller attached to the revenue at the time of its collection; and the mere receipt of revenue which the recipient never had the right to command, but acquired burdened by the duty to pay it to the beneficial owner, does not constitute taxable income.

It was held in *Barnes* v. *Alexander*, 232 U.S. 117, that whether a contract purports to convey an interest in a fund or merely express an agreement to pay over a fund when received, on receipt of the fund the payee becomes a trustee for the person entitled to it. This case was cited and its

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doctrine was applied in tax cases discussed below, *Shellabarger* v. *Commissioner*, (7 Cir.) 38 F.2d. 566, 567-568, and *Central Life Assurance Soc.* v. *Commissioner*, (8 Cir.) 51 F.2d. 939, 941. So here, while petitioner received revenue in excess of what it was permitted to retain, it never had or claimed the right to do anything with it except pay it into escrow. The situation is within the decision of this Court in *Commissioner* v. *Wilcox*, 327 U.S. 404, 408:

> "The very essence of taxable income, as that concept is used in section 22 (a), is the accrual of some profit, gain or benefit to the taxpayer.
>
> . . . . . .
>
> "For present purposes, however, it is enough to note that the taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute gain. . . . the bare receipt of property or money wholly belonging to another lacks the essential characteristics of a gain or profit within the meaning of section 22 (a)."

For the purposes of taxation it is command of income and its benefits that is significant.

Griffiths v. *Helvering*, supra, 308 U.S. 355, 357-358.
Higgins v. *Smith*, 308 U.S. 473, 478.

It is incontrovertible that as to the segment of revenue passing through escrow to seller:

(a) Petitioner was under an admitted and defined unconditional obligation to turn it over conformably to the requirements of the contract under which petitioner derived the right to collect the revenue.

(b) Petitioner never had or claimed any command over this revenue, or any right to do anything with it except as prescribed in the contract.

(c) Petitioner received no benefits from this revenue, no credit upon any debt, no enhancement of assets, tangible or intangible, no increase of privileges, no decrease in duties.

The segment of revenue passing to seller during the five year "contract period" lacks, so far as petitioner is concerned, the qualities characteristic of income. This fact confirms the conclusion that the revenue accruing to seller has the character of a reservation of income from the joint enterprise to be conducted under the transferred rights during the "contract period".

The situation is not changed by assuming the correctness of the court's conclusion that the shared revenue arrangement "was used as a way of arriving at a fair purchase price". In *Thomas* v. *Perkins*, *supra*, (301 U.S. 655) and *Burton-Sutton*

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Oil Co., v. *Commissioner, supra,* (328 U.S. 25) there is much more basis for such an assumption. Yet the opinions indicate that the decisions would not have been varied by an express finding to this effect. These and other cases cited make it clear that such a conclusion, even if validly made, does not support a concept of a capital investment from which no benefits can ever accrue to buyer under any circumstances.

C. The decision below is in conflict with decisions of other courts of appeal both as to the tax effect of contracts for sale reserving income to the seller, and the tax effect of receiving income as a trustee or conduit for another. Cases involving reserved income include the following:

Central Life Ass. Co., Mutual v. *Commissioner,* (8 Cir.) 51 F.2d. 939, holds that where a contract for the purchase of a life insurance business provided that the purchaser assume all the liabilities of the transferor company and as a "further consideration" turn over the earnings for twenty-two years of a specified division of the business purchased, whatever these earnings might be, the purchaser was not taxable for these earnings. "These earnings never became the absolute property of petitioner, and it could lawfully do with them but one thing, which was to pay them over in accordance with the contract. It secured no beneficial interest whatsoever from them." (p. 941) The case indicates the interrelation between the reserved interest doctrine and the rule that command of income is the basis for taxation of it.

Bettendorf v. *Commissioner*, (8 Cir.) 49 F. 2d. 173, held that where the legal title to securities was transferred with a provision that the transferor should have the dividends for life, the dividends were income to the transferor and not to the transferee who acquired title burdened by the duty to account for income.

Porter Royalty Pool v. *Commissioner*, (6 Cir.) 165 F.2d. 933, cert. den. 334 U.S. 833, held that where a fractional interest in oil produced by lessees was the only medium through which landowner-lessors could derive a profit, this was a reserved economic interest which was alienable and the earnings were income to the transferee and taxable to it.

Hamme v. *Commissioner*, (4 Cir.) 209 F.2d. 29, cert. den. 347 U.S. 954, holds that a right retained by a seller to share in net profits is of itself a retained economic interest. There owners of the fee conveyed it "in fee simple forever" subject to the condition that the transferee make payments in accordance with a contract requiring royalty payments of a percentage of net inome from operations. It was held that despite the absolute form of the conveyance the transferee was obligated to exploit the minerals and the transferor had retained an economic interest so that the royalties were income to it and not a capital investment by transferee.

The court below apparently recognized the conflict between its decision and the doctrine of the *Hamme* case for it said the *Hamme* case "does appear to suggest rather broadly that any partici-

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pation in net profits constitutes a reservation of an 'economic interest' for tax purposes; but the actual decision was as to the taxability of receipts from a permanent mineral royalty right reserved by a vendor."

In fact what the *Hamme* case suggests is the conclusion from the analysis of the decisions of this Court. There is, therefore, a recognized conflict between the interpretation of those decisions by the *Hamme* case and by this case. Nor can this conflict be treated as the result of *dicta* in the *Hamme* case. For it was a statement of the law upon which that decision was based.

The only precedent which the court below found "in accord" with its decision is *United States* v.*Jones*, (10 Cir.) 194 F.2d. 783. But the court erred in its interpretation of that decision. There a contract of sale rested partly in parol. From the parol evidence the district court found the intention to be that the buyer was to "beome the absolute owner . . . . with complete control and dominion . . . ." and that payments to be received by seller from a lease of the property sold were capital. The decision by the Court of Appeals was that the conclusion of fact was sustained by substantial evidene. It is apparent that the *Jones* case was decided upon the basis of an express exclusion of a retained interest, similar to the situation in *Helvering* v. *Elbe Land Co.*, 303 U.S. 372, as interpreted in *Burton-Sutton Oil Co.*, v. *Commissioner*, 328 U.S. 25, 28. Thus, the *Jones* case is not in accord with the decision below, for here the contract was in writing, there was no express

exclusion, no personal obligation; and control by the buyer was limited expressly to five years. If the *Jones* case had the effect asserted by the court, it would follow that in the *Jones* case the Commissioner was taking a position which was in direct conflict with his claim here.

D. There is a clear conflict between the decision below and decisions of other courts of appeal that income should be taxed to the beneficiary, not to a trustee or mere conduit. The decisions so in conflict include the following cases.

Shellabarger v. *Commissioner*, (7 Cir.) 38 F. 2d. 566, holds that a legatee who, as a consideration for the settlement of a will contest, became obligated to turn over the income of a portion of the estate as that income was received, was not taxable for funds so received and turned over. It was not her income because the interest of her payee attached to it immediately upon receipt, as in *Barnes* v. *Alexander*, supra, (232 U.S. 117).

In *Mountain Producers Corp.* v. *Commissioner*, (10 Cir.) 92 F.2d. 78, two corporations had agreed that if either acquired a leasehold interest in certain oil property they would have equal rights in the lease and divide equally the net proceeds. It was held that the taxable income of the nominal lessee should not include the part passing under the contract to share benefits because, (quoting from *Central Life* v. *Commissioner*, supra, 51 F.2d. 939, 941), "a cardinal purpose of the income tax laws is to tax the income to the person who has the right or beneficial interest therein and not to throw the burden on a mere

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collector or conduit through whom or which the income passes." The case involved state immunity from federal taxes and was reversed on that ground, 303 U.S. 376.

In 112 *West 59th Street Corp.* v. *Commissioner*, (C.A.D.C.) 68 F.2d. 397, an investment trust took title to real estate in a corporation organized for the purpose as a matter of convenience in transferring title. The investment trust paid the purchase price and the carrying charges and received the selling price. The court, quoting and approving the doctrine of *Central Life* v. *Commissioner, supra*, 51 F.2d. 939, 941, as to taxation of a mere conduit, held that the corporation was not taxable for the capital gain because it could retain no benefits of the re-sale as against the equitable owner, the investment trust.

Brown v. *Commissioner*, (1 Cir.) 54 F.2d. 563, cert. den. 286 U.S. 556, dealt with the result of a 1918 order limiting wool dealers to a 5% profit. Sums in excess of that amount could not be retained by the dealer. Due to a dispute as to the method of disposition of this excess, it was carried by the dealer in a special account awaiting determination of the correct payee. It was held that the dealer was not required to report as income the amount of profit in excess of 5%, since he made no claim of ownership and might not be allowed to retain this excess.

E. The conflict between the decision below in this case and other decisions of this court and of the several courts of appeal presents a question of federal law of important public concern. The

effect of the conflict upon the public is twofold.

The conflict will create uncertainties as to the tax effect of contracts. Thereby it will not only promote litigation between taxpayers and the government, but it will deter the making of a useful type of contract which reserves to the seller a part of the income of the thing sold. A purchaser of property subject to a reserved right to income to be paid to seller cannot deal with any certainty that he will not have to pay taxes on the seller's share of the income because until this conflict is resolved a court may infer that the reserved income plan was adopted as a means of arriving at a fair price. Should the court take such a view the effect might be to increase the purchase price by fifty or more percent.

Until the decision in the instant case a purchaser of property, segments of the income of which were retained by the seller, had the guidance of a clear rule established by the decisions of this court and the courts of appeal as indicated above. These decisions made it clear that when the seller's right to payment was entirely dependent on earnings derived from the property sold, these earnings are taxable to the seller and not to the buyer, without regard to "technical title" or any "form of legal interest" in the property (*Thomas* v. *Perkins*, supra, 301 U.S. 655) or "formalities of the conveyancer's act" (*Anderson* v. *Helvering*, supra, 310 U.S. 404). The "practical consequences of the provision for payments of that type" lead to its being "regarded as a reservation from the granting clause." (Id. 411) To what

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extent and where this rule will survive the impact of the decision of the court of appeals in the instant case cannot be foretold by the citizens affected.

The conflict will prevent the operation of the Internal Revenue Code as a nationwide scheme of taxation uniform in its application. Presumably the district courts will follow the decision of the courts of appeal in their respective circuits. This will preclude the operation in the second circuit of a rule in harmony with that enforced in some of the other circuits. It is important to avoid such a situation, for as this Court said in *United States* v. *Pelzer*, 312 U.S. 399, 402:

> ". . . . as we have often had occasion to point out, the revenue laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation uniform in its application."

Accord:

Helvering v. *Stuart*, 317 U.S. 154, 161.
Lyeth v. *Hoey*, 305 U.S. 188.
United States v. *Joliet & C. R. Co.*, 315 U.S. 44.

WHEREFORE, your Petitioner, Vermont Transit Co., Inc., prays that a writ of certiorari may issue out of, and under the seal of this Court, directed to the United States Court of Appeals for the Second Circuit, commanding that Court to certify and send to this Court a full and complete transcript of the record and of the proceedings of the said Court of Appeals in the above

cause, numbered 22824 on its docket, and there entitled Vermont Transit Co., Inc., Petitioner, v. Commissioner of Internal Revenue, Respondent, to the end that this cause may be reviewed and determined by this Court as provided for by the statutes of the United States; and that the judgment herein of said Court of Appeals be reversed by the Court, and for such further relief as to this Court may seem proper.

Dated this 14th day of April 1955.

VERMONT TRANSIT CO., INC.

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APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 5

October Term, 1954
Argued December 9, 1954
Decided January 21, 1955

Docket No. 22824

VERMONT TRANSIT CO., INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Before CLARK, Chief Judge, and SWAN and MEDINA, Circuit Judges.

Petition by Vermont Transit Co., Inc., for review of a decision of the Tax Court of the United States, 19 T.C. 1040, Arnold Raum, Judge, upholding the Commissioner's assessment of income taxes for the years 1942 and 1943 against petitioner upon earnings placed in escrow pursuant to an earlier agreement by petitioner for the purchase of its business. Affirmed.

Guy M. Page, Burlington, Vt. (Charles W. Tye, Summit, N. J., on the brief), for petitioner.

Louise Foster, Sp. Asst. to Atty. Gen., Washington, D. C. (H. Brian Holland, Asst. Atty. Gen., and Ellis N. Slack, Sp. Asst. to Atty. Gen., Washington, D. C., on the brief), for respondent.

CLARK, Chief Judge.

Petitioner asks review of a decision of the Tax Court of the United States, reported at 19 T.C. 1040, holding it taxable on all income earned in 1942 and 1943 from the operation of its busses pursuant to certain franchises acquired by it in 1941 from Frontier Coach Lines, Inc. It contests the interpretation given by the Commissioner and the Tax Court to the agreement of purchase and sale between it and Frontier. That agreement conveyed the franchises to petitioner outright, but provided that part of the consideration therefor should consist of earnings from the franchises in the five years following the agreement. An elaborate formula provided for the allocation of earnings for these five years, during which petitioner was bound to continue operations unless Frontier consented to abandonment, change, or alteration of routes. The earnings allocated to Frontier were to be put in escrow by petitioner, and it is the taxability of these earnings to petitioner that is here under consideration.

Whether an agreement of purchase and sale has conveyed all of the property interests involved so as to make the purchaser fully taxable on all of the resultant earnings or whether the contract has reserved an interest in the seller on which the seller is taxable is a question of the intent of the parties

in making the agreement. This intent may be inferred from the wording of the agreement and from the surrounding circumstances. *Thomas* v. *Perkins*, 301 U.S. 655; *Anderson* v. *Helvering*, 310 U.S. 404. We agree with the conclusion of the Tax Court that the facts here point to the outright sale of a capital asset without reservation of interest. The purchase agreement specified, inter alia:

> "1. The Buyer agrees to buy from the Seller and the Seller agrees to sell to the Buyer the operating rights of the Seller upon routes * * * more specifically described hereinabove * * *.
>
> "2. Seller will irrevocably transfer title to the operating rights to the Buyer on the Transfer Date * * *.
>
> "3. The Buyer, in consideration of the transfer of the operating rights, agrees to make payments to the Seller as follows:
>
> "(a) The Buyer agrees to pay to the Seller on the Transfer Date Three Thousand Five Hundred Dollars ($3,500) in cash.
>
> "(b) The Buyer agrees to make payments to the Seller on the basis of the gross annual revenue from and mileage of operations by the Buyer during a period commencing on the Transfer Date and terminating five years thereafter * * *.
>
> "7. It is understood and agreed by and between the Seller and the Buyer that, from and after the Transfer Date, the operating rights of the Seller as described in paragraph 1

of this Agreement shall be unified with the operating rights of the Buyer, and that the Buyer shall have complete jurisdiction and control over operations under these rights and shall assume complete responsibility for same."

These provisions indicate that no control was reserved in the Seller.

This reading is re-enforced by the history of the agreement. It appears that the parties for a long time disagreed as to the proper valuation to be placed on the franchises, which had not been profitable in the hands of Frontier. To solve this problem, the parties first resorted to a lease arrangement with option to buy to enable the making of a more accurate appraisal of value. Only when this expedient was disapproved by the Interstate Commerce Commission was recourse had to the Purchase Agreement now before us. It is logical to say, therefore, that the device of contingent payments was used as a way of arriving at a fair purchase price. And if the escrow payments represented purchase money they could not at the same time represent a reservation of interest in the seller. We therefore agree with the conclusion reached by Judge Raum in his carefully reasoned opinion below.

This interpretation is in accord with the reading given to a similar agreement by the Tenth Circuit in *United States* v. *Jones*, 10 Cir., 194 F.2d 783. Other cases—both those relied on by the petitioner, such as *Anderson* v. *Helvering*, *supra*, 310 U.S. 404; *Thomas* v. *Perkins*, *supra*, 301 U.S. 655; *Peck* v. *C.I.R.*, 2 Cir., 77 F. 2d 857,

certiorari denied *Peck* v. *Helvering*, 296 U.S. 625; *Central Life Assur. Soc. Mut.* v. *C.I.R.*, 8 Cir., 51 F.2d 939; *Bettendorf* v. *C.I.R.*, 8 Cir., 49 F.2d 173; *Shellabarger* v. *C.I.R.*, 7 Cir., 38 F.2d 566, and those cited by the Commissioner, which include *Burnet* v. *Logan*, 283 U.S. 404; *Northern Trust Co. of Chicago* v. *United States*, 7 Cir., 193 F.2d 127, certiorari denied 343 U.S. 956; and *De Guire* v. *Higgins*, 2 Cir., 159 F.2d 921, certiorari denied 331 U.S. 858—are sufficiently different in their facts as not to be controlling with respect to the narrow factual issue upon which this decision must turn. There is nothing in the law to which they advert inconsistent with our result here. *Hamme* v. *C.I.R.*, 4 Cir., 209 F.2d 29, certiorari denied 347 U.S. 954, does appear to suggest rather broadly that any participation in net profits constitutes a reservation of an "economic interest" for tax purposes; but the actual decision was as to the taxability of receipts from a permanent mineral royalty right reserved by a vendor.

Since the escrow payments were thus part of the purchase price for the franchises, they constituted funds expended for the acquisition of a capital asset and were not a deductible business expense. See I.R.C. § 24(a)(2). Furthermore the Commissioner was correct in assessing the taxes on the income in the year in which it was earned by the taxpayer. The fact that the proper allocation of escrow payments between petitioner and Frontier under the formula was not immediately determinable was of no relevance to the taxability of these funds.

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The decision of the Tax Court is affirmed.

SWAN, Circuit Judge, dissenting:

The majority opinion does not, I think, give an adequate picture of the transactions between the petitioner, hereafter referred to as the buyer, and Frontier Coach Lines, Inc., hereafter referred to as the seller. There is no dispute as to the facts. They were stipulated and were "so found" by the Tax Court. My statement of them will consist of quotations from the Tax Court's opinion.

"Frontier, which for some time had been operating at a loss, approached petitioner in 1939 in an endeavor to negotiate a sale of some of its operating rights (hereinafter also referred to as the 'rights' or 'francises'). Such a sale appeared to be advantageous to both parties. * * * At some stage in the negotiations, Frontier indicated an asking price of $25,000 for the rights, which were valued, as intangible assets, on its books at $12,872. The petitioner insisted that the franchises had a nominal value only. Both parties desired to effecuate a purchase and sale, but they could not agree on a purchase price under the existing conditions.

"It was, therefore, agreed on August 14, 1940, that Frontier would lease the rights to petitioner until December 31, 1945, granting petitioner an option to renew the lease for an additional five years. On August 26, 1940, the parties entered into a further agreement whereby petitioner was given an option to purchase the rights at a price to be agreed upon by the parties. An arbitration procedure was provided in the event that the parties failed to agree upon a purchase price. * * * The

lease was to go into effect when approved by the Interstate Commerce Commission (hereinafter called the 'Commission').

"Petitioner made application to the Commission for approval of the lease and option to buy, and a hearing was given before an examiner. The examiner submitted a proposed report recommending denial of approval of the agreement because it was thought that Frontier's predicament would only be increased if at the termination of the lease petitioner decided not to purchase the rights. The proposed denial of approval was without prejudice to the submission of an agreement pertaining to immediate purchase of the operating rights.

"No exceptions were filed to the proposed report of the examiner and a supplemental application was filed with the Commission on February 10, 1941. This application requested approval of a purchase agreement entered into on February 4, 1941, between petitioner and Frontier. The agreement referred to the parties as 'buyer' and 'seller'. The provisions of the purchase agreement were similar in many respects to the provisions of the lease. The seller was to 'irrevocably transfer' the title to the operating rights 120 days after the Commission approved and auhorized such transfer. The buyer, petitioner, was to pay $3,500 to the seller when title was transferred. The primary and secondary amounts were to be computed in the same manner as in the lease agreement except that the buyer was to recover $3,500 in excess of the primary amount prior to making any deposits into the escrow account. The funds remaining in

excess of the primary and secondary amounts were to be divided equally between the parties. The arrangement for payments into escrow and the disposition of the funds so deposited, as outlined above, was to be operative for a period of five years. The seller reserved the right to inspect the books of the buyer. The seller again promised to maintain a connecting route with the buyer's routes and the buyer promised not to change or disconinue any of the acquired routes without the seller's approval. By an order dated May 4, 1941, the purchase was approved and authorized by the Commission; title to the rights was transferred on July 1, 1941; and an escrow agreement was entered into with a Burlington, Vermont, bank.

* * * *

"The amounts of $54,262.18 and $37,347.78 represent the difference between the revenues paid into the escrow account in 1942 and 1943, and the amounts petitioner received back from escrow in those years. The petitioner asserts that it received no benefit from those funds since they were collected by petitioner for Frontier. It urges that Frontier reserved an economic interest in the operating rights and that therefore the inclusion of those amounts in gross income in 1942 and 1943 was an error. The respondent contends that the unrecovered revenues paid into escrow by petitioner were payments to Frontier of the purchase price of the franchises; that the money represcented income to the petitioner when received and the subsequent payment to Frontier should not change their character. The respondent further asserts

that as capital expenditures, the amounts are not deductible by petitioner."

Having thus stated the facts and the contentions of the parties, the Tax Court's opinion says: "The tax consequences of this transaction must be determined not only by the form in which it was cast, as the petitioner urged, but also by the substance of what occurred." With this statement of law I am in thorough accord. But I am unable to agree with the way in which the Tax Court and my brothers have applied it. Judge Raum says that "The language of the agreement of February 4, 1941 is framed wholly in terms of purchase and sale." I disagree. The seller agreed (1) to transfer title to the operating rights after authorization by the Commission, and (2) to maintain a connecting route with the buyer's routes. The buyer agreed (1) to pay $3,500 cash on transfer of the rights, (2) not to discontinue any of the acquired routes without the seller's consent, (3) to pay out of the operating revenue certain amounts, computed in the manner stated in the agreement, to the escrow bank for the benefit of the seller, and (4) to indemnify and hold the seller harmless for any injury to persons or property arising out of any of the operations conducted pursuant to the agreement. To treat all sums received by the seller through the escrow bank as consideration for the transfer of title seems to me to disregard both the form and the substance of the transaction. Surely some part of the consideration received must be ascribed to the seller's promise to maintain a connecting route. By the contract the buyer agreed

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to pay $3,500 for transfer of the rights, with the possibility of recovering it from operating earnings. It was willing to risk this amount, but it never agreed to pay anything more for the transfer of title. Instead it gave the seller a right to a defined share of the earnings, if any, for a term of five years. The escrow arrangement, the provisions for accountings, for inspection of records, for continuance of operations without abandonment or change in the routes during the contract period unless the seller should consent, and for indemnification of the seller against claims arising out of the buyer's operations, as well as the seller's promise to maintain a connecting route, all indicate to my mind that the substance of the transaction was a joint enterprise, the earnings of which were to be shared. In my opinion the agreement constitutes a reservation by the seller of the right to a specified share of the income earned by the buyer's operation of buses under the "franchises" transferred. From that share the buyer could not benefit.

The Tax Court's opinion does not dispute the rule that a transferee of property who does not acquire a right to the benefits of the income is not subject to be taxed for that income. It denies that the seller reserved a right to a specified share of the income and it attempts to distinguish some of the cases cited by the petitioner.[1] I do not think them distinguishable in principle. In my opinion the decision of the Tax Court should be reversed.

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[1] Petitioner's brief cites, among other authorities, *Barnes* v. *Alexander*, 232 U.S. 117; *Thomas*

v. *Perkins*, 301 U.S. 655; *Anderson* v. *Helvering*, 310 U.S. 404, 411; *Central Life Assur. Soc.* v. *Commissioner*, 8 Cir., 51 F.2d 939, 941; *Bettendorf* v. *Commissioner*, 8 Cir., 49 F.2d 173; *Shellabarger* v. *Commissioner*, 7 Cir., 38 F.2d 566; *Commissioner* v. *Turney*, 5 Cir., 82 F.2d 661; *Hamme* v. *Commissioner*, 4 Cir., 209 F.2d 29.

JUDGMENT

COURT OF APPEALS
SECOND CIRCUIT

At a stated term of the United States Court of Appeals for the Second Circuit held at the United States Court House in the City of New York on the twenty-first day of January nineteen hundred and fifty-five, present Hon. Charles E. Clark, Chief Judge, Hon. Thomas W. Swan and Hon. Harold R. Medina, Circuit Judges.

Vermont Transit Co., Inc.,
Petitioner.

v.

Commissioner of Internal Revenue,
Respondent.

Appeal from The Tax Court of the United States.

This cause came on to be heard on the transcript of record from the The Tax Court of the United States and was argued by counsel.

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ON CONSIDERATION WHEREOF, it is now hereby ORDERED, ADJUDGED, and DECREED, that the order of said The Tax Court of the United States be and it hereby is affirmed.

It is further ordered that a mandate issue to said The Tax Court of the United States in accordance with this decree.

s/ A. DANIEL FUSARO,
Clerk.

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QUESTION PRESENTED

Whether the taxpayer was taxable on the portion of the earnings of bus routes operated by it which under the terms of a purchase agreement it paid over to the company from which it purchased operating rights in the routes.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 22. GROSS INCOME.
>
> (a) [as amended by Sec. 1 of the Public Salary Tax Act of 1939, c. 59, 53 Stat. 574] *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
>
> * * * * *
>
> (26 U. S. C. 1952 ed. 22.)

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STATEMENT

There is no dispute as to the facts, which were accepted by the Tax Court as stipulated (R. 6–9). The taxpayer, a Vermont corporation, operated bus routes in Vermont, New Hampshire, Massachusetts, Maine, and New York. A portion of its routes was also served by a similar carrier, Frontier Coach Lines, Inc. (hereinafter referred to as "Frontier"). (R. 7.)

Frontier, which had been operating at a loss, in 1939 offered to sell some of its operating rights to the taxpayer. While both parties desired to effectuate the transaction, they could not agree on price. (R. 7.) It was, therefore, agreed that Frontier would lease the rights to taxpayer until December 31, 1945, granting taxpayer an option to renew the lease for an additional five years, with an option to purchase at a price to be agreed upon by the parties. The lease provided that the taxpayer was to recover its expenses in operating the franchises on a stipulated mileage basis; that all revenues in excess of this amount were to be deposited monthly in an escrow account, unless there were unrecovered deficits in the expenses from previous months; that funds from the escrow were to be paid to Frontier on the basis of one cent a mile travelled in operation of the routes; that any revenues remaining were to be apportioned 75 percent to the taxpayer and 25 percent to Frontier; that the latter agreed to keep a connecting line in operation; and that the

lease was to go into effect when approved by the Interstate Commerce Commission. (R. 7–8.)

Taxpayer applied to the Commission for approval of the lease and option to buy. After a hearing, the examiner recommended disapproval of the agreement because Frontier's predicament would only be increased if at the termination of the lease taxpayer decided not to purchase the rights. (R. 8.)

A supplemental application was thereupon filed with the Commission requesting approval of a purchase agreement entered into on February 4, 1941, between taxpayer and Frontier. The agreement referred to the parties as "buyer" and "seller." The provisions of the purchase agreement were similar in many respects to the provisions of the lease. The seller was to "irrevocably transfer" the title to the operating rights 120 days after the Commission approved and authorized such transfer. The taxpayer, who was the buyer, was to pay $3,500 to the seller when title was transferred. The expenses of operation were to be computed in the same manner as in the lease agreement and the buyer was to recover expenses and $3,500 prior to making any deposits from operating revenues in the escrow account. The seller was then to get one cent a mile and the remainder was to be divided equally between the parties. This arrangement was to be operative for a period of five years. The seller re-

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served the right to inspect the books of the buyer. The seller again promised to maintain a connecting route with the buyer's routes and the buyer promised not to change or discontinue any of the acquired routes without the seller's approval. By an order dated May 4, 1941, the purchase was approved and authorized by the Commission; title to the rights was transferred on July 1, 1941; and an escrow agreement was entered into with a Burlington, Vermont, bank. (R. 8–9.)

The amounts paid from the escrow account to Frontier in 1942 and 1943 amounted to $54,262.18 and $37,347.78, respectively. The taxpayer claimed that it received no benefit from such amounts because they were collected for Frontier and, in this connection, the taxpayer alleged that Frontier had reserved an economic interest in the operating rights. The Commissioner determined deficiencies on the ground that the above sums were payments on the purchase price of the franchises, that such sums were gross income of the taxpayer when received, and that their character was not changed by subsequent payment to Frontier. (R. 6, 9.)

The Tax Court approved the Commissioner's determination and held that there were deficiencies in income tax for 1942 and 1943 in the amounts of $11.19 and $178.92, respectively. (R. 5, 13.) The Court of Appeals affirmed the decision of the Tax Court. (Pet. 24–29.)

ARGUMENT

1. The court below correctly held that payments made to the Frontier Coach Lines were part of the purchase price for the operating rights and that such sums had been previously earned by taxpayer in its business and were taxable to it under Section 22 of the Internal Revene Code of 1939, *supra*. In reaching this decision, the court pointed out that whether an agreement of purchase and sale conveys the entire interest in the property involved so as to make the purchaser taxable on all of the resultant earnings depends on the intent of the parties to be determined from the language of the agreement and from the circumstances surrounding it.

The facts here indicate an outright sale of a capital asset by Frontier without any reservation of an interest therein. The purchase agreement specified, *inter alia* (R. 44–45, 48):

> 1. The Buyer agrees to buy from the Seller and the Seller agrees to sell to the Buyer the operating rights of the Seller upon routes * * * more specifically described hereinabove * * *.
>
> 2. Seller will irrevocably transfer title to the operating rights to the Buyer on the Transfer Date * * *.
>
> 3. The Buyer, in consideration of the transfer of the operating rights, agrees to make payments to the Seller as follows:
>
> (a) The Buyer agrees to pay to the Seller on the Transfer Date Three Thou-

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sand Five Hundred Dollars ($3,500) in cash.

(b) The Buyer agrees to make payments to the Seller on the basis of the gross annual revenue from and mileage of operations by the Buyer during a period commencing on the Transfer Date and terminating five years thereafter * * *.

* * * * *

7. It is understood and agreed by and between the Seller and the Buyer that, from and after the Transfer Date, the operating rights of the Seller as described in paragraph 1 of this Agreement shall be unified with the operating rights of the Buyer, and that the Buyer shall have complete jurisdiction and control over operations under these rights and shall assume complete responsibility for same.

* * * * *

These provisions show that no control or interest was reserved by the seller, as is also indicated by the circumstances leading up to the agreement. As pointed out above, Frontier, which had been operating at a loss for some time, offered to sell its operating rights to the taxpayer in 1939 but they could not agree as to price. Accordingly, in the following year it was agreed that Frontier would lease its rights to taxpayer but the Interstate Commerce Commission refused to approve a lease. Consequently the parties executed an agreement for sale of the rights to taxpayer. This agreement was approved by the Interstate

Commerce Commission and in doing so it ordered taxpayer "before recording payment of any part of the purchase price upon its books, from time to time" to submit its related journal entries to the Commission. Thus, in contending here that the sole consideration for the purchase was the initial payment of $3,500, taxpayer disregards the Commission's interpretation of the agreement recognizing the later payments as being part of the purchase price. That was also the taxpayer's own interpretation of the agreement when it filed an application in 1943 (one of the taxable years here) with the Commission for permission to make certain changes in the purchase agreement. (R. 65–68.)

There is nothing in the facts to indicate that Frontier reserved any interest in the operating rights covered by the purchase agreement or that it received any portion of the payments as earned income. Thus, the Tax Court properly found (R. 11) that the payments involved here were actually income earned and received by taxpayer by operating its own buses with its own employees pursuant to the newly acquired operating rights and that such income was paid into escrow and eventually on to the seller to discharge the obligation which taxpayer assumed in order to acquire such rights.

2. There is no conflict in the decisions. Each case necessarily turns on the terms of the agreement therein and the pertinent surrounding cir-

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cumstances. Certainly there is a clear distinction between the instant case and those involving oil and gas agreements where ownership is by custom very frequently divided. *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U. S. 25; *Kirby Petroleum Co.* v. *Commissioner,* 326 U. S. 599; *Thomas* v. *Perkins,* 301 U. S. 655; *Hamme* v. *Commissioner,* 209 F. 2d 29 (C. A. 4th), certiorari denied, 347 U. S. 954; and *Porter Royalty Pool* v. *Commissioner,* 165 F. 2d 933 (C. A. 6th), certiorari denied, 334 U. S. 833. As this Court pointed out in the *Burton-Sutton Oil Co.* case, Congress has recognized the peculiar character of the business of extracting natural resources and has provided for an equitable division of depletion allowances between assignors who reserve rights and assignees who are the operators. But even in cases involving oil property there has been no radical departure from the general principle that a person who buys property outright must pay taxes on the income subsequently produced therefrom even though it is agreed in advance that all of such income for a designated period will be used to pay the purchase price of the property covered by the agreement. See *Helvering* v. *Elbe Oil Land Co.,* 303 U. S. 372, holding that all of the oil rights there had been sold although part of the assignor's consideration was being paid from a percentage of the net profits.

Other cases relied on by taxpayer are also distinguishable. In *Central Life Assur. Soc., Mut.*

v. *Commissioner,* 51 F.·2d 939 (C. A. 8th), two types of life insurance business were involved but, while the company transferred both, it is clear that it actually sold only one of them and retained the beneficial interest in the other. Thus the income from the latter was properly held not taxable to the transferee. In *Mountain Producers Corp.* v. *Commissioner,* 92 F. 2d 78, 81 (C. A. 10th), it was held that the taxpayer who received the income involved, under a trust agreement was merely a conduit for the beneficial owner and was therefore not taxable on such income. Similarly, in *Shellabarger* v. *Commissioner,* 38 F. 2d 566 (C. A. 7th), where a testamentary beneficiary contracted with her sister to give her a share of the trust fund if she would not contest the will, the former was held not taxable on trust income she was obligated to pay to her sister. The same conclusion was reached in *Bettendorf* v. *Commissioner,* 49 F. 2d 173 (C. A. 8th), where a donor, who specifically reserved for life a right to the dividends from the stock which was the subject of the gift, was held taxable on such dividends.

But there was no reservation here of any interest in the operating rights and the taxpayer was not a conduit to pay over income earned by Frontier. Instead, taxpayer had purchased the entire interest in the rights and agreed to pay for them out of its earnings produced by its

own employees operating its own buses under the newly acquired rights.

CONCLUSION

This case presents no question of general importance. The decision of the court below is correct and there is no conflict. The petition for a writ of certiorari should be denied.

Respectfully submitted,

SIMON E. SOBELOFF,
Solictor General.
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MAY 1955.

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